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In the Supreme Court of the United States

OCTOBER TERM, 1958.

No. 585

NICHOLAS FERRAIOLO,
Petitioner,

v.

F. R. NEWMAN,
Respondent.

PETITION FOR WRIT OF CERTIORARI.

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To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Petitioner Nicholas Ferraiolo prays that a writ of certiorari issue to the United States Court of Appeals for the Sixth Circuit to review the judgment of that Court in Cause No. 13,345, wherein that Court affirmed a judgment entered by the United States District Court for the Northern District of Ohio granting the Respondent's motion for summary judgment.

OPINIONS BELOW.

The Opinion of the District Court, Judge Paul Jones, granting the motion of the Defendant-Respondent for summary judgment has not been reported. It is printed in the Joint Appendix filed in the Court of Appeals at pages 40a to 43a. Nine extra copies of the Joint Appendix have been filed with this Petition.

The Order of the District Court appears in the Joint Appendix filed in the Court of Appeals at pages 43a and 44a.

The Opinion of the Court of Appeals, Judge Potter Stewart (Chief Judge Charles C. Simons, and Judge Shackleford Miller, Jr. concurring), is in the Appendix to this Petition, page 22, and is reported at 259 F. 2d 342.

The Judgment of the Court of Appeals is in the Appendix to this Petition at page 28.

JURISDICTION.

The judgment presented for review is dated and was entered September 24, 1958.

There was no order respecting re-hearing below nor granting an extension of time within which to petition for a writ of certiorari in this Court.

Jurisdiction of this Court is invoked under 28 U. S. C. Section 1254(1), upon petition for certiorari filed within the ninety days prescribed by 28 U. S. C. Section 2101(c). These sections are as follows:

Section 1254:

"Cases in the courts of appeals may be reviewed by the Supreme Court by the following methods:

(1) By writ of certiorari granted upon the petition of any party to any civil or criminal case, before or after rendition of judgment or decree;"

Section 2101(c):

"Any other appeal or any writ of certiorari intended to bring any judgment or decree in a civil action, suit or proceeding before the Supreme Court

for review shall be taken or applied for within ninety days after the entry of such judgment or decree. A justice of the Supreme Court, for good cause shown, may extend the time for applying for a writ of certiorari for a period not exceeding sixty days."

THE QUESTION PRESENTED FOR REVIEW.

—The Law.

Sections 16(a) and 16(b) of the Securities Exchange Act of 1934 were enacted to prevent the unfair use of information that may have been obtained by corporate officers, directors, or major stockholders. They provide that if such an insider realizes any profit from the purchase and sale or sale and purchase of any equity security issued by his corporation and if the purchase and sale are within any period of less than six months, then the profit shall inure to and be recoverable by the corporation.

—The Facts.

The Respondent, a director of the Ashland Oil and Refining Company, acquired a block of its common stock by conversion of preferred. Less than six months later, after a substantial rise in the price of the common, he sold some of it.

The corporation, Petitioner intervening, sued to recover Respondent's profit.

The conversion ratio of the preferred was protected against dilution and the relative market prices of the two stocks approximately reflected this ratio. Shortly before Respondent converted his preferred it was called for redemption at a price below its market value, so that if he had permitted the preferred to be redeemed Respondent would have suffered a substantial loss.

—Respondent's Choice.

But this loss could be avoided either by conversion of the preferred into common or by outright sale of the preferred. Respondent chose to convert.

It is possible that this choice was guided by an insider's knowledge that the price of the common was likely to go up.

—The Question.

In the terms and circumstances of this case is the acquisition of common stock by conversion of preferred a "purchase" within the meaning and intent of Sections 3(a)(13) and 16(b) of the Securities Exchange Act of 1934, 15 U. S. C. Sections 78c(a)(13) and 78p(b)?

The Court below answered "No."

Petitioner believes the answer should be "Yes."

THE STATUTE INVOLVED.

This case arises under Sections 16(a) and 16(b) of the Securities Exchange Act of 1934, 15 U. S. C. Sections 78p(a) and 78p(b). These sections are as follows:

> "(a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered on a national securities exchange, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security or within ten days after he becomes such beneficial owner, director, or officer, a statement with the exchange (and a duplicate original thereof with the Commission) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been any change in such ownership during such month, shall file with the exchange a statement (and

a duplicate original thereof with the Commission) indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.

(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter, but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."

Section 3(a)(13) of the Securities Exchange Act of 1934, 15 U. S. C., Section 78(a)(13) defines the term "purchase" as follows:

"The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire."

STATEMENT OF THE CASE.

—The Parties.

Petitioner Ferraiolo is a stockholder and Respondent Newman was a Director of Ashland Oil and Refining Company. Joint Appendix pp. 3a, 6a, 11a.

—The Two Classes of Stock.

Ashland had two classes of stock, common and preferred, both listed on the New York Stock Exchange, a national securities exchange. Joint Appendix pp. 3a, 6a, 10a. The preferred stock was cumulative, callable, and convertible into common. Joint Appendix p. 23a. Originally the conversion ratio was 1:1, but the Articles of Incorporation by which it was created provided that the ratio would be adjusted to compensate for any change in the amount of common outstanding by way of a stock dividend or stock split. A 10 percent stock dividend on the common in May, 1951, raised the ratio so one share of preferred would get 1.1 shares of common. Joint Appendix p. 8a.

The convertibility of the preferred was reflected in its market price, for when the price of the common climbed above the redemption price of the preferred the price of the preferred followed that of the common. Joint Appendix pp. 19a, 21a.

—The Call For Redemption.

On November 15, 1951, the Company issued a call for redemption of the preferred stock on December 17, 1951. Joint Appendix p. 23a. Of the 228,358 shares of the preferred stock that were outstanding on the date the call was issued Respondent F. R. Newman held 43,720. Joint Appendix p. 7a. The redemption price, 27¼ per share, was approximately nine dollars a share less than the cur-

rent market price of the preferred or of the 1.1 shares of common for which it could be exchanged. Joint Appendix pp. 21a, 23a. Thus to hold the preferred until it was redeemed would yield Newman nine dollars a share less than if he were to sell it for cash before the redemption date, or convert it into common.

—Respondent's Election.

On November 23, 1951, Newman exercised his right to exchange the preferred for common, and for his 43,720 shares of Ashland preferred he received 48,092 shares of Ashland common, which then had a market price of about 33⅛. Joint Appendix pp. 6a, 21a. Between December 17, 1951, and January 22, 1952, he sold 20,000 shares of the common at prices ranging from 35⅞ to 42¼. Joint Appendix pp. 25a, 27a.

—This Action.

On demand of the Petitioner the Company sued in the United States District Court for the Northern District of Ohio to recover Respondent's profit, pursuant to Section 16(b) of the Securities Exchange Act of 1934, 15 U. S. C. Section 78p(b). Petitioner intervened, and all three parties moved for summary judgment.

The principal issue before the Court was whether Newman's conversion of Ashland's preferred stock into common stock constituted a "purchase" of the common within the intent and meaning of Sections 3(a)(13) and 16(b) of the Securities Exchange Act of 1934, 15 U. S. C. A. Sections 78c(a)(13) and 78p(b).

The District Court, Paul Jones, Chief Judge, found for the defendant, Respondent Newman. Petitioner Ferraiolo appealed to the United States Court of Appeals for the Sixth Circuit, which affirmed.

—Rationale Below.

The rationale of the Court below was that Newman's election to convert his shares of Ashland preferred stock into common was "involuntary," since "he would have lost approximately nine dollars a share if he had allowed his preferred shares to be redeemed." While he could have sold his preferred, "it can hardly be said that a failure to sell is tantamount to a purchase," the Court said.

REASONS FOR GRANTING THE WRIT.

A. The decision of the United States Court of Appeals for the Sixth Circuit, review of which is sought hereby, is in direct conflict with the decision by the United States Court of Appeals for the Second Circuit in the case of *Park & Tilford, Inc. v. Schulte*, 160 F. 2d 984, cert. denied, 332 U. S. 1016 (1947). In the *Park & Tilford* case, the conversion of preferred shares into common stock was held to constitute a "purchase" of common stock within the intent and purpose of Section 16(b) of the Securities Exchange Act of 1934, 15 U. S. C. Section 78p(b). The decision by the United States Court of Appeals for the Sixth Circuit involving the instant case, *Ferraiolo v. Newman*, [illegible] 2d 342, has held that the conversion of preferred shares into common stock is not a "purchase" of the common within the meaning and intent of Section 16(b) of the Act, *supra*.

That this conflict between the Second Circuit and the Sixth Circuit cannot be explained away by distinguishing the two cases is shown by the reasoning of two other cases in the Second Circuit, *Blau v. Mission Corporation*, 212 F. 2d 77, Cert. denied, 347 U. S. 1016, and *Roberts v. Eaton*, 212 F. 2d 82, cert. denied, 348 U. S. 827 (1954).

B. The Court of Appeals for the Sixth Circuit has decided an important question of Federal law which has not

been, but should be, settled by this Court and has decided it in a way that conflicts with the applicable decisions by the Court of Appeals for the Second Circuit. These conflicting decisions involve important questions of national scope which are of the greatest importance and concern to the investing public of the United States as well as to the management of all corporations listed upon any national securities exchange. The decision by the Court of Appeals for the Sixth Circuit finds no sanction in the Securities Exchange Act of 1934 and is in conflict with the stated Congressional purpose and intent.

ARGUMENT.

A. CONFLICTS WITH DECISIONS OF OTHER COURTS OF APPEALS.

1. PARK & TILFORD CASE.

The decision in point is *Park & Tilford, Inc. v. Schulte*, 160 F. 2d 984 (1947), decided by the United States Court of Appeals for the Second Circuit. In this case Judge Clark stated the rule that Petitioner believes should govern this case as follows:

> "We think a conversion of preferred into common stock followed by a sale within six months is a 'purchase and sale' within the statutory language of Section 16(b). Whatever doubt might otherwise exist as to whether a conversion is a 'purchase' is dispelled by definition of 'purchase' to include 'any contract to buy, purchase, or otherwise acquire.' Section 3(a)(13). Defendants did not own the common stock in question before they exercised their option to convert; they did afterward. Therefore they acquired the stock, within the meaning of the Act. The Act certainly applies as well to executed acquisitions as to executory contracts to acquire. Not otherwise could the Act accomplish the Congressional purpose

to protect the outside stockholders against at least short-swing speculation by insiders with advance information. Smolowe v. Delendo Corporation, supra, 2 Cir., 136 F. 2d 231, 235, 148 A. L. R. 300; Kogan v. Schulte, D. C. S. D. N. Y., 61 F. Supp. 604."

a. Attempted Distinction.

The Court of Appeals sought to distinguish the *Park & Tilford* case on three grounds:

(1) Newman's conversion of preferred stock into common was in a very real sense involuntary.

(2) The preferred stock in the *Park & Tilford* case was "nonmarketable" and the "marketable common stock * * * was 'more valuable.'"

(3) The convertibility of the preferred shares in the *Park & Tilford* case was not protected against dilution.

(1) Involuntary Conversion.

(a) THREE CHOICES.

In the *Park & Tilford* case it was claimed that the conversion was involuntary and this defense was met by Judge Clark with the following language:

"The transaction may not, as defendants assert, be withdrawn from operation of the Act on the theory that the conversion was a forced, and not a voluntary, act by defendants. Whatever might be the considerations involved in that situation, it is clear that here defendants were not forced to convert, but instead made an everyday business decision as to the most profitable of three courses of action—redemption, conversion, or outright sale of their preferred. Indeed, the contention that defendants were forced to convert is somewhat absurd, in view of the fact that since defendants controlled plaintiff they could have prevented the passage of the redemption resolu-

tion or rescinded it after it had been passed." (160 F. 2d pp. 987, 988.)

While it is true in this case that Respondent Newman did not hold majority control of Ashland and presumably did not have it within his power to prevent or rescind the call for redemption of his preferred, the remainder of Judge Clark's answer is fully applicable here. Newman had the same three choices that the Schultes had in the *Park & Tilford* case.

(b) KEY STATEMENT IS A DECEPTIVE OVERSIMPLIFICATION.

The opinion of the Court of Appeals acknowledges that Newman could have sold the preferred shares on the open market instead of converting them but counters this acknowledgment with the key statement:

"* * * it can hardly be said that a failure to sell is tantamount to a purchase."

This statement of the Court of Appeals is a deceptive oversimplification.

[1] Complaint Is Against Purchase and Re-sale.

In the first place, Petitioner's complaint is not against a failure to sell but against a decision by Newman to sell his preferred stock for common—thus purchasing the common—rather than to sell the preferred for cash, combined with a profitable re-sale of the common thus acquired within less than six (6) months thereafter.

[2] Key Statement Begs the Question.

In the second place, if the above-quoted statement of the Court of Appeals is re-phrased to state the real issue it appears to be completely circular, stating nothing but the conclusion to be reached. Consider the following paraphrase:

"It can hardly be said that a decision to convert the preferred stock into common rather than sell it for cash is tantamount to a purchase of the common."

(2) Common More Valuable.

The distinction drawn by the Court of Appeals on the ground that the Schultes "exchanged nonmarketable preferred shares for marketable common stock which was 'more valuable'" ignores the fact that in this case too Newman acquired common stock that was really more valuable than the preferred with which he bought it. Surely the fact that the preferred stock was about to be redeemed at a price $9.00 lower than the market value of the common that he could get for it demonstrates that the common was "more valuable" than the preferred.

(a) ONLY PARTIALLY EQUIVALENT.

We may acknowledge that Newman's preferred and common were economic equivalents in *some* sense, that is that the preferred could be exchanged for common and that it was protected against dilution of the conversion privilege by stock splits or stock dividends applied to the common. But this is by no means a complete equivalence, for the preferred and common stock had separate bundles of rights that could not be enjoyed simultaneously. The preferred had guaranteed and cumulative though limited dividends and preference on dissolution. On the other hand, it was subject to having these rights extinguished by redemption and the preferred shareholder's only protection was but a partial one: to convert his preferred stock into common shorn of the preferences. Moreover, once the call for redemption was issued the preferred stock immediately became a far less desirable stock to hold. The holder of preferred had to convert to common or sell the preferred for cash in order to avoid its redemption at a considerable drop in price.

(3) Protection Against Dilution.

Protection against dilution is insufficient.

That *only a complete and mathematical equivalence will provide immunity* is the lesson to be drawn from two other cases, *Blau v. Mission Corporation*, 212 F. 2d 77, and *Roberts v. Eaton*, 119 F. Supp. 362, 212 F. 2d 82. These cases too were decided by the Second Circuit.

2. BLAU v. MISSION CORPORATION.

a. The Facts of the Case.

Blau v. Mission Corporation, supra, involved transactions in the stock of Tide Water Associated Oil Company. Mission Corporation owned a large block of Tide Water stock, and in December, 1948, conveyed it to a newly organized wholly-owned subsidiary, Mission Development Corporation, in exchange for the stock of the subsidiary. Shortly afterwards Mission Corporation distributed part of the stock in the subsidiary to its own shareholders. Thereafter Mission Development stock was listed on the New York Stock Exchange and was freely traded there. Meanwhile Mission continued to buy Tide Water stock and in January, 1951, conveyed a second block of it to Mission Development, the subsidiary, on the same terms as before.

Plaintiff sued on the theory that each of these exchanges with Mission Development constituted a sale of the Tide Water stock, with which plaintiff sought to match purchases of Tide Water stock that had been made within six months before or after each sale, claiming liability for profits under Section 16(b).

b. Mathematically Exact Equivalence—Immunity.

The Court held that the first exchange of Tide Water stock for that of Mission Development, the subsidiary, was not a sale since Mission Development was a wholly-

owned subsidiary and Mission Corporation did not divest itself of real ownership of the Tide Water stock by this exchange.

In other words, what it held after the exchange was the equivalent of what it held before—with mathematical exactness.

c. No Longer Equivalent—Liability.

The second exchange with Mission Development, however, did constitute a sale, the Court held, because by that time Mission Corporation was no longer the sole stockholder of Mission Development. By the stock dividends, the public listing, and the market sales of Mission Development stock, Mission Development had achieved independent value before the second exchange. Although the defendant's commitment in Tide Water stock was not immediately reduced by the exchange the Court observed that the ownership had been one step removed and the intervening Mission Development stock was independently valued.

d. The Test: Possibility of Use of Inside Information.

The Court said:

> "It is not beyond conceit that an insider would possess information which when publicly released would depress Tide Water prices while enhancing those of Development. Moreover, if Mission were to receive stock in an exchange such as this, and thereafter sell it within six months, we have no doubt that the exchange would be a 'purchase' within Section 16(b)."

Thus, although there was a direct relationship between the value of the Tide Water stock and the value of the stock of Mission Development, the subsidiary, the intrinsic value of Mission Development being absolutely

tied to the underlying Tide Water, the economic equivalence was not so mathematically exact at the time of the second exchange as to immunize it from the application of the statute.

The situation left leeway enough to make it possible for an insider to be guided by and to profit from inside information. Therefore the insider was held liable.

3. ROBERTS v. EATON.

a. The Facts of the Case.

In *Roberts v. Eaton, supra,* the defendants were the former controlling stockholders of Old Town Corporation, principally Eaton and his family, who held 45.9 percent of the corporation's stock. Desiring to sell out and retire, Eaton found that he could sell the stock more readily and at better prices if the corporation's one class of common stock was re-classified into common and preferred, to be sold separately. The directors proposed such a re-classification and informed the stockholders fully of the reasons for it and a special meeting of the stockholders gave their approval by a more than two thirds vote. A month after the re-classification, the defendants sold the stock. To the plaintiff's contention that the receipt by Eaton of the preferred and common stock on re-classification was a purchase, the District Court replied that such a re-classification was not a purchase since the equivalence was mathematically exact: each stockholder held afterwards *exactly* what he had held before. On appeal the District Court's judgment was affirmed.

b. Factors That Make for Liability.

Judge Clark's opinion reviewed the cases in which liability had been established and concluded that where acquisitions of stock were held to be purchases within the Act, there were three common characteristics:

(1) There was an individual option of the insider to acquire the security or not as he saw fit;

(2) The securities acquired were part of a pre-existing class, substantial portions of which were publicly held, and which had an independent value in a pre-existing market;

(3) The securities received were either those of a different corporation from the one whose securities were given in exchange (*Blau v. Mission Corporation*, 212 F. 2d 77; second half of *Blau v. Hodgkinson*, 100 F. Supp. 361), or the insider's acquisition resulted in his holding a different proportional interest in the securities of the issuer (*Park & Tilford, Inc. v. Schulte*, 160 F. 2d 984; and the first half of *Blau v. Hodgkinson*, 100 F. Supp. 361).

Judge Clark found that these elements were not present in *Roberts v. Eaton, supra.*

c. Factors That Make for Immunity.

He observed that the fact that the defendants' control of the corporation made the conversion a voluntary one on their part lost some of its force when the re-classification and proposed subsequent sale were disclosed and time-consuming ratification by the stockholders was required. He remarked also that like treatment of all stockholders would in most cases remove the possibility of abuse. He agreed with the District Court that after the re-classification the defendants had held the same interests and rights as before until they sold their stock. He observed that the intrinsic value of a new issue relates directly to the underlying property; any variance depends

on market preferences of which an insider would have no more knowledge than the rest of the world.

Judge Clark concluded with the warning that the fact that after the re-classification the defendants had held the same interest as before would not be sufficient to immunize the transaction from the liabilities of Section 16(b) if it stood alone and perhaps that none of the factors he mentioned would do so, but in cumulative effect they did.

d. Factors that Make for Liability Here.

Returning to Judge Clark's analysis of the factors that make for liability, we find they are all present here.

(1) There was an individual option of the insider to acquire the security or not as he saw fit: as we have shown, Newman could have elected to sell his preferred stock for cash instead of for common.

(2) The common stock acquired here by conversion of the preferred was part of a pre-existing class, publicly held, having an independent value in a pre-existing market; it was not a new issue of whose value an insider would have no more knowledge than the rest of the world.

(3) Newman's acquisition of the common did result in his holding a different proportional interest in the securities of Ashland. Obviously, after the conversion he held a larger proportion of common and a smaller proportion of preferred. This is the only sense in which there was a change in proportional interest in the *Park & Tilford* case. We have already observed the differences between the preferred and common with respect to dividends and liquidation rights.

e. Factors Claimed to Make for Immunity Here.

The Sixth Circuit apparently sought to bring this case within Judge Clark's factors that make for immunity, for it asserted:

> "all of the preferred shareholders were treated alike; full disclosure was made to them, the conversion worked no material change in the proportional equity ownership of Ashland."

(1) The Sixth Circuit Missed the Point.

We come here to one of the points at which the Sixth Circuit seems to have failed most seriously to grasp the true significance of the facts of the case. Only a few lines before the above statement its opinion referred to the fact that the holders of more than 99 percent of the outstanding preferred shares chose to convert them to common. This is probably much of the source of what Petitioner believes to be the error of the Court below, for the proportion of preferred stock that finally got converted rather than redeemed is utterly immaterial. The proportion would be large even if all of those who held preferred stock on November 15, 1951, when the call was issued, sold their stock for cash. Those who bought it would proceed to convert rather than allow redemption.

(2) The Point Is the Possibility of Use of Inside Information.

Remembering that the purpose of the statute is to protect the public, that is, outsider stockholders, against unfair use of information available only to insiders we must ask whether there is a possibility that Newman used inside information in deciding to convert his preferred rather than sell it for cash. Obviously, since he was an insider and since, in fact, the market price of the common stock ..at he bought with his preferred did rise rapidly in

the next two months, his transaction here could well have been guided by inside information. It is here that we must apply the test as to whether all stockholders were treated alike. The Court of Appeals said that they were and that full disclosure was made to them. *But of course there is no evidence that outsiders were given any inside information that the common was likely to go up after Newman converted his preferred to common.*

(3) Who Was Hurt?

Who are the outsiders that were hurt by this transaction? The answer is, those who sold their preferred stock in ignorance that the common was going up; those who lost an opportunity to buy the preferred that Newman might have put on the market if he had not converted his preferred to common; and, since we must look at the whole transaction, those who later bought common from Newman in anticipation of further price increases and found instead a general though slight decline setting in shortly after Newman completed his sales.

(4) Objective Standard of Proof.

We do not claim to have any knowledge or evidence that Newman did in fact have inside information of the character we have supposed for the purpose of this analysis, but proof of such actual knowledge is not required by the statute. The statute establishes an objective standard of proof. *Smolowe v. Delendo Corporation*, 136 F. 2d 231 (1943); *Gratz v. Claughton*, 197 F. 2d 46 (1951); *Walet v. Jefferson Lake Sulphur Company*, 202 F. 2d 433 (1953). The Court of Appeals admitted as much when it asserted that Newman's inactivity as a director was entirely irrelevant, citing the *Smolowe* and *Gratz* cases; and, as the Court of Appeals said, counsel for Newman readily conceded it.

(5) The Correct Rule.

What must govern the decision here is the *possibility* that Newman was guided by inside information when he chose to convert rather than to sell his preferred stock or when he subsequently sold his common less than six months later.

It is a curious fact that the Court of Appeals drew the correct rule out of the cases but failed to apply it to the facts of this case. The Court of Appeals' opinion states:

> "The standard that emerges from these decisions can be simply stated: Every transaction which can reasonably be defined as a purchase will be so defined, if the transaction is of a kind which can possibly lend itself to the speculation encompassed by Section 16(b). Accepting that standard, we turn to the relevant circumstances of the present case."

(6) Incorrect Application of the Rule.

Having enunciated this excellent statement of the rule and its intention to turn to the relevant circumstances of the present case the Court of Appeals omitted all reference to the controllingly relevant circumstance that Newman's decision to convert rather than sell could have been guided by inside knowledge. This circumstance makes the transaction one of a kind that *can* possibly lend itself to the speculation encompassed by Section 16(b) and thus the transaction should be defined a purchase.

4. CONCLUSION.

Since it failed to understand this circumstance the decision of the Court of Appeals for the Sixth Circuit is in clear conflict with those of the Second Circuit in *Park & Tilford, Inc. v. Schulte, Blau v. Mission Corporation*, and *Roberts v. Eaton*.

The petition for certiorari should be granted.

B. AN IMPORTANT QUESTION OF FEDERAL LAW THAT SHOULD BE SETTLED BY THIS COURT.

So far as counsel for Petitioner has been able to find there has been no decision of this Court on the scope and sweep of Section 16(b) of the Securities Exchange Act of 1934. Most of the decisions on this Section have come from the Second Circuit and this Court has repeatedly denied certiorari. We do not question the wisdom of the Court's practice as to these past cases for they have enunciated a consistent and vigorous policy of full enforcement of the intent of the statute. But in this case a conflict has developed between the Sixth Circuit and the Second that should be resolved. For if the present case is allowed to stand it would create the appearance of a loophole that seems likely to encourage much insider speculation and to produce considerable litigation before it can be either closed or firmly opened.

The petition for certiorari should be granted.

Respectfully submitted,

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APPENDIX.

OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

(Filed September 24, 1958.)

Before SIMONS, Chief Judge, MILLER and STEWART, Circuit Judges.

STEWART, Circuit Judge. This appeal involves the applicability of Section 16 (b) of the Securities Exchange Act of 1934, 15 U. S. C. A., § 78p (b). That section provides that any profit realized by a corporate director resulting from his purchase and sale of the corporation's stock within less than six months shall inure to the corporation.[1]

In 1948 the appellee, Newman, acquired 43,720 shares of the convertible preferred stock of Ashland Oil and Refining Co. (Ashland) as a result of a merger. At that time Newman became a director of Ashland. More than three years later, on November 23, 1951, he exercised the right to convert these shares into 48,092 shares of Ashland com-

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[1] If the corporation is the issuer of equity securities listed on a national securities exchange. Section 16 (a) and (b) provide.

"(a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered on a national securities exchange, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security or within ten days after he becomes such beneficial owner, director, or officer, a statement with the exchange (and a duplicate original thereof with the Commission) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been any change in such ownership during such month, shall file with the exchange a statement (and a duplicate original thereof with the Commission) indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.

(Continued on following page)

mon stock. Within six months thereafter, he sold 20,000 shares of Ashland common stock at prices in excess of the November 23, 1951, price.

Upon demand of the appellant Ferraiolo, a stockholder, Ashland brought this action against Newman to recover Newman's profits resulting from the above transaction. Ferraiolo was permitted to intervene. The district court entered a summary judgment in favor of Newman, holding that the transaction was not covered by Section 16 (b) of the Act. Only the intervenor has appealed.

It can fairly be gathered from the abbreviated record that Newman was a very inactive director of Ashland, and that during the period in question he was not in fact privy to any inside information concerning the company. Such considerations, however, are entirely irrelevant to the applicability of Section 16 (b), as counsel for Newman

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(Continued from preceding page)

"(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection." 15 U. S. C. A., § 78p (a) and (b).

readily concede. *Smolowé v. Delendo Corp.*, 136 F. 2d 231, 235-36 (2 Cir., 1943), cert. den. 320 U. S. 751; *Gratz v. Claughton*, 187 F. 2d 46, 49-50 (2 Cir., 1951), cert. den. 341 U. S. 920.

It is evident that the narrow question in this case is whether Newman's acquisition of the Ashland common stock upon conversion of his preferred stock on November 23, 1951, was a "purchase" within the meaning of Section 16 (b) of the Act. If so, Newman was liable to the corporation for the profit he realized when he sold 20,000 shares of the common stock within the ensuing six months. *Smolowe v. Delendo Corp., supra*, at 237-39; *Gratz v. Claughton, supra*, at 50-52.

The statute itself furnishes no definition that would supply an easy answer to the question. It provides only that the term "purchase" *includes* "any contract to buy, purchase, or otherwise acquire." 15 U. S. C. A., § 78(c)(13). It is thus apparent that while the transaction here was not one falling within the ordinary concept of a "purchase,"[2] nevertheless the statutory definition would not necessarily exclude it.

It is also apparent, however, that the question is not in any event primarily a semantic one, but must be resolved in the light of the legislative purpose—to curb short swing speculation by insiders. Most of the litigation involving the meaning to be given "purchase" in Section 16 (b) has arisen in the District Court for the Southern District of New York. A series of decisions in that court and in the Court of Appeals for the Second Circuit have marked out an approach to the problem which is pragmatic rather than technical. Each case has been decided on its

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[2] "The generally understood meaning of 'purchase' is to acquire something by one's own act or agreement for a price." *Shaw v. Dreyfus*, 172 F. 2d 140, at 142 (2 Cir., 1949), cert. den. 337 U. S. 907.

own facts, and the enunciation of a "black letter rubric" has been expressly avoided. *Park & Tilford, Inc. v. Schulte*, 160 F. 2d 984, cert. den. 332 U. S. 761 (1947); *Shaw v. Dreyfus*, 79 F. Supp. 533, 172 F. 2d 140, cert. den. 337 U. S. 907 (1949); *Truncale v. Blumberg*, 80 F. Supp. 387 (1948); *Blau v. Hodgkinson*, 100 F. Supp. 361 (1951); *Blau v. Ogsbury*, 210 F. 2d 426 (1954); *Blau v. Mission Corporation*, 113 F. Supp. 153, 212 F. 2d 77, cert. den. 347 U. S. 1016 (1954); *Roberts v. Eaton*, 212 F. 2d 82, cert. den. 348 U. S. 827 (1954).

The standard that emerges from these decisions can be simply stated: Every transaction which can reasonably be defined as a purchase will be so defined, if the transaction is of a kind which can possibly lend itself to the speculation encompassed by Section 16 (b). Accepting that standard, we turn to the relevant circumstances of the present case.

The preferred shares which Newman acquired in 1948 were convertible by the owners at any time prior to July 15, 1958, into Ashland common shares on a share-for-share basis. However, the convertibility of the shares was protected against dilution by a provision that the conversion

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This is substantially the same test as that proposed in "The Scope of 'Purchase and Sale' under Section 16 (b) of the Exchange Act," 59 Yale L. J., at 513 (1950):

"Some transactions, however, are neither clearly included in, nor excluded from, the statutory definition of 'purchase' and 'sale.' As used in Section 16 (b), 'purchase' may or may not include the receipt, by virtue of stock ownership of stock rights and stock dividends. 'Sale' may or may not include gifts, whether for charitable or non-charitable purposes. The exercise of a conversion feature may or may not be either or both. If insider trading is to be effectively deterred, 'purchase' and 'sale' must consequently be interpreted in the light of Section 16 (b)'s purpose. The question whether to include particular transactions within their scope therefore must be tested by the following standard—is inclusion necessary to recover profits made from short term insider speculation?"

ratio should be adjusted in the event of any change in the number of outstanding common shares, so that, in 1951 when Ashland declared a ten per cent stock dividend on its common shares, the conversion ratio became 1 preferred for 1.10 common, and additional common shares were reserved and set aside to correspond with the changed rate. Both Ashland preferred and Ashland common were registered securities and listed on the New York Stock Exchange. The preferred shares were fully redeemable by Ashland at a fixed price upon thirty days written notice but during the thirty-day period the conversion privilege remained unimpaired.

On November 15, 1951, Ashland called all of the then outstanding convertible preferred shares for redemption at $27 a share on December 17, 1951. During almost all of the preceding year Ashland common had been selling on the New York Stock Exchange at prices in excess of this redemption price. By reason of their undilutable conversion privilege, Ashland preferred shares had been selling at a price equivalent to the common, when adjusted to reflect the 1.10 conversion ratio. At the time the preferred shares were called for redemption, the market price of Ashland preferred and Ashland common (adjusted) was approximately $36 per share, or $9 per share more than the redemption price. Faced with a choice of permitting his preferred shares to be redeemed at $27 a share or converting them into common shares selling for $36, Newman naturally took the latter course, as did the holders of more than 99 per cent of the outstanding preferred shares.

The convertible preferred shares which Newman acquired in 1948 were subject at any future time to call for redemption. Once the market price of the common stock rose above the redemption price of the preferred, the preferred, with its undilutable conversion privilege, became

in the objective judgment of the market place, the economic equivalent of the common. The real effect of Ashland's subsequent call of the preferred for redemption was simply to force the surrender of the preference features of the preferred. All of the preferred shareholders were treated alike; full disclosure was made to them; the conversion worked no material change in the proportional equity ownership of Ashland.

This, then, is a case quite different from *Park & Tilford, Inc., v. Schulte*, 160 F. 2d 984 (2 Cir., 1947), cert. den. 332 U. S. 761, upon which the appellant heavily relies. In that case the insiders exchanged nonmarketable preferred shares for marketable common stock which was "more valuable." See *Blau v. Mission Corporation*, 212 F. 2d 77, at 81 (2 Cir., 1954), cert. den. 347 U. S. 1016. The convertibility of the preferred shares in that case was not protected against dilution. The two classes of shares were not, therefore, in any sense economic equivalents. Moreover, the conversion in that case was voluntary in that the insiders had complete control of the corporation and could, therefore, determine whether the preferred would be called for redemption. See *Roberts v. Eaton*, 212 F. 2d 82, at 83 (2 Cir., 1954), cert. den. 348 U. S. 827.

Here, by contrast, Newman's conversion of preferred stock into common was in a very real sense involuntary. He would have lost approximately nine dollars a share if he had allowed his preferred shares to be redeemed. While it is true that he could have sold the preferred shares on the open market instead of converting them, it can hardly be said that a failure to sell is tantamount to a purchase.

In short, an analysis of the circumstances of this case leads to the conclusion that the district court was not in error in holding Newman free from Section 16 (b) liability. Newman's conversion of Ashland preferred to Ash-

land common had none of the economic indicia of a purchase; it created no opportunity for profit which had not existed since 1948. The transaction was not one that could have lent itself to the practices which Section 16.(b) was enacted to prevent.

The judgment of the district court is affirmed.

JUDGMENT OF THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

(Filed September 24, 1958.)

Appeal from the United States District Court for the Northern District of Ohio.

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Ohio, and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be and the same is hereby affirmed.